

**STATE OF CALIFORNIA
DEPARTMENT OF INSURANCE**
45 Fremont Street
San Francisco, CA 94105

RH03029826

June 2, 2006

**Title 10
Proposed Revisions to Sections 2632.5, 2632.8 and 2632.11
Optional Automobile Insurance Rating Factors**

Summary and Response to Volume 5 Comments Received During
45-day Comment Period

Responses to Common Comments:

1.1: Common Comments:

- Rates should be cost-based / substantially related to the risk of loss
- A driver's location (zip code) should be a critical factor in calculating insurance rates
- Drivers in rural regions of the state should not be forced to subsidize the rates for drivers in urban regions of the state.
- The proposed regulations will result in arbitrary rates because of the act of pumping and tempering, the resulting cross-subsidies, etc.

Response:

The Commissioner's regulations continue to permit a driver's location to be an important factor in setting insurance rates. While the proposed regulations preserve the importance of location in setting insurance rates, however, Proposition 103 provides that the factors which determine a driver's rates should be weighted in a specific order of importance. The proposed regulations will implement the weight ordering requirement of Proposition 103, which is codified in Insurance Code section 1861.02(a). The ballot pamphlet to Proposition 103 promised, in part, that "103 forces insurance companies to base your rates on your driving record first, rather than on where you live. That means good drivers throughout the state will pay less than they do now, while bad drivers will pay more." The ballot pamphlet also establishes that "In general, the measure requires that rates and premiums for automobile insurance be determined on the basis of the insured person's driving record, miles driven and number of years of driving experience." Finally, in the clearest possible terms, section 1 of Proposition 103 declares under the heading "Findings and Declaration" that "automobile insurance rates shall be determined primarily by a driver's safety record and mileage driven." To the extent that the cost of insurance may increase for some low income drivers and may affect businesses in rural or urban parts of the state, the increase will be determined primarily by the driver's safety record, mileage driven and years of driving experience, as Proposition 103 intended.

While some commentators believe that territory is the most important characteristic for determining the likelihood of an accident, there are other equally important, if not more important considerations which insurers often neglect under the existing regulations. Driving safety record, for example, is a very strong predictor of the risk of loss for an accident. Similarly, annual mileage driven bears a strong correlation to the risk of loss for an accident. The Department commonly observes instances where insurers do not collect meaningful data regarding the correlation between some of the mandatory factors and the risk of loss. One rating factor where insurer data is lacking is the mandatory factor of annual mileage driven. By way of example, the Commissioner has observed that one insurer arbitrarily places insurers into one of merely two categories: drivers that drive less than 7,500 miles per year and drivers who drive more than 7,500 drivers per year. Other examples show similar neglect for data collection regarding the mandatory factors. The existing regulations do not encourage insurers to develop better data collection for the mandatory rating factors, because they allow insurers to fall back on the crutch of territory for auto rating. The proposed regulations will stimulate insurers to conduct better data collection for mileage and driving safety record. This, in turn, will enhance the relationship to the risk of loss between those rating factors and the rates developed under the proposed regulations.

This comment contends that unlike the existing regulations, the proposed regulations will not be cost based and/or substantially related to the risk of loss.

The Court in *Spanish Speaking Citizens' Foundation v. Low* concluded that the language in Insurance Code section 1861.02(a)(4) which requires optional factors to be "substantially related to the risk of loss" also requires that the mandatory factors, and their order of importance must be substantially related to the risk of loss. The Commissioner notes, however, that Insurance Code section 1861.02(a)(4) expressly makes reference to the optional factors alone. Indeed, the Commissioner believes that Proposition 103 sought to bring fairness to automobile insurance rates, in part, by requiring the mandatory factors of driving safety record, annual miles driven and years of driving experience to assume greater weight than the optional factors irrespective of the mandatory factors' relationship to the risk of loss. While the Commissioner disagrees with the Court's interpretation of Insurance Code section 1861.02(a)(4) and the meaning of "substantially related to the risk of loss", the Commissioner recognizes that the *Spanish Speaking* decision represents the current state of the law, and his response takes into account the Court's interpretation in *Spanish Speaking*.

Notwithstanding the Commissioner's interpretation of Insurance Code section 1861.02(a)(4), the *Spanish Speaking* Court determined that for purposes of the weight ordering mandate, "interpretations that preserve a substantial relationship between premiums and the risk of loss ... are [] to be favored over those that would produce arbitrary rates." (*Spanish Speaking Citizens' Foundation v. Low* (2000) 85 Cal.App.4th 1179, 1227.) The commentator contends that the existing regulations are substantially related to the risk of loss, but that the proposed regulations are not and therefore are invalid. The fundamental assumption here is that the present rate regulations ensure cost-based rating. This assumption is demonstrably incorrect.

First, Proposition 103 as well as other laws reflect the voters' and Legislature's intent that public policy objectives must often prevail over considerations of cost-based pricing. For example, many insurers contend that a policyholder's lack of a history of prior insurance bears a strong correlation to the risk of an automobile accident. Despite insurers' preference for using the absence of prior insurance as a rating factor, Insurance Code section 1861.02(c) prohibits its use. (See, e.g., *Foundation for Taxpayer and Consumer Rights, et al. v. Garamendi* (2005) 132 Cal. App. 4th 1354.) Other examples of laws which require public policy to take precedence over an argument of cost-based pricing abound. (See, e.g. Ins. Code section 11628 & 679.71 [sex, race, color, religion, national origin, or ancestry cannot by itself constitute a risk for which a higher rate may be charged].) Directly at issue, Insurance Code section 1861.02 requires that automobile rates be determined by applying "in decreasing order of importance" the mandatory factors of driving safety record, annual mileage driven and years of driving experience, followed by any optional factors adopted by the Commissioner. Thus, concerns about cost-based pricing and the relationship to risk of loss often must yield to greater concerns of public policy, as reflected in the weight ordering requirements mandated by section 1861.02(a).

Moreover, the Department has observed numerous examples of rates which are not cost-based under the existing regulations, both within the course of this rulemaking proceeding as well as during its review of rate filings submitted to the Department. The Department's Rate Filing Branch commonly receives rate filings from insurers under the current regulatory system in which the insurers select rate assignments that do not reflect the cost of providing the insurance. For example, although an insurer's loss experience might require an indicated rate relativity for a particular zip code for a cost-based rate, insurers commonly select different rate relativities which markedly deviate from the indicated rate relativity.

While the existing regulations do not result in rates that are purely cost-based, the Court in *Spanish Speaking Citizens* concluded that regulations which "preserve a substantial relationship between premiums and the risk of loss ... [are] to be favored over those that would produce arbitrary rates." (*Spanish Speaking Citizens' Foundation v. Low* (2000) 85 Cal.App.4th 1179, 1227.) The proposed regulations, like the existing regulations, do not reflect rates which are in lockstep with a given insurer's loss experience. This situation exists not only because Proposition 103 dictates that some public policy objectives must often override the relationship to the risk of loss, but also because insurers often prefer to select rates which are different from the insurer's loss experience. Nevertheless, the proposed regulations, like the existing regulations, do preserve a substantial relationship between premiums and the risk of loss, and therefore cannot be considered arbitrary or contrary to Insurance Code sections 1861.02(a) and 1861.05.

Similarly, some commentators contend that rating factors which are enhanced or diminished (i.e. – "pumped" or "tempered") to bring the factors into the appropriate weight order are not cost-based and therefore not substantially related to the risk of loss. Under the existing regulations, however, the Department has observed instances of rate

filings in which insurers "pump" the mandatory factor of years driving experience, so that they can increase the influence of zip code on an insured's rate. Indeed, State Farm's comments regarding this rulemaking proceeding recognize that the existing regulations could require pumping or tempering in some cases. Just as the Department recognizes that public policy objectives may take precedence over cost-based rating, the Department recognizes that rates can still be substantially related to the risk of loss despite the fact that some rating factors are pumped or tempered as necessary to bring the rating factors into the correct weight order required by Insurance Code section 1861.02.

Because the proposed regulations ensure that zip code (territory) may be as high as the fourth-most important factor in calculating an insured's premium, rates will still be substantially related to the loss costs associated with a particular region of the state. The Commissioner's proposed regulations achieve the most appropriate balance among the objectives of Proposition 103. Unlike the existing regulations, the proposed regulations ensure that rates will be determined primarily by driving safety record and mileage driven, while still permitting other optional rating factors with a substantial relationship to the risk of loss to have a significant influence on premiums.

1.2: Common Comments:

- The existing regulations produce lower premiums for more good drivers than other alternatives.
- The proposed regulations will raise rates for good drivers in rural regions of the state.
- The proposed regulations will raise rates for low income drivers in rural regions of the state.

Response:

While the Court of Appeal in *Spanish Speaking Citizens v. Low* concluded that the current regulations are lawful, the Court also acknowledged that a method identical to the Commissioner's proposed regulations may also represent a permissible interpretation of Proposition 103. To the extent that the commentator suggests that the current regulatory system produces lower premiums for more good drivers, the Commissioner disagrees, as he has observed substantial evidence to the contrary. Indeed, because the proposed regulations ensure that how you drive will be more important than where you live, it is axiomatic that more good drivers will experience rate decreases under the proposed regulations than under the current regulatory system.

1.3 Common Comments:

- The proposed regulations should be fair for all regions of the state and not just urban regions of the state.
- The Commissioner's proposed regulations ignore the impact upon rural and suburban regions of the state.

Response:

The Commissioner has considered the impact upon both rural and urban drivers in the state. After receiving a petition for rulemaking in May of 2003, the Commissioner personally attended seven informational meetings in regions of the state ranging from Fresno and Chico to Los Angeles and Oakland to discuss the potential impact of the proposed regulations upon rates for urban and rural regions of the state. The Commissioner observed numerous instances – in rural as well as urban locations – where drivers with identical characteristics would pay unjustifiably different premiums simply because they live in the "wrong" zip code.

For example, the Commissioner has observed substantial variations in premium not only for consumers living within just a few miles of each other, but even for neighbors who live in adjoining zip codes. In fact, the differentials in territory relativities between adjacent zip code pairs for some companies do not closely follow the patterns of the industrywide pure premium data. In looking for examples of arbitrary rates and premiums, one need look no further than the premiums established under the existing regulations. Examples such as these demonstrate that the existing regulations are neither purely cost-based nor consistent with Proposition 103's distaste for zip code rating. The Commissioner's proposed regulations will prevent similar disparity between zip codes in the future, by requiring insurers to give more consideration to how you drive rather than where you live. Not only does this approach make sense, it is the approach that the Proposition 103 ballot pamphlet promised to the voters.

1.4 Common Comments:

- According to studies performed by Robert Downer and Mercer Actuarial Consulting, Inc., the proposed regulations will result in an XX% increase for XX drivers. Rates will increase for 52 out of 58 counties.

Response:

At the outset, it is important to point out that any projection of premium that a particular consumer or even a particular region of the state may pay due to the proposed regulations is a matter of substantial speculation. The Commissioner's proposed regulations provide a significant degree of discretion to insurers to decide upon the most prudent manner for implementing the proposed regulations. This discretion exists, in part, because the proposed regulations permit insurers to use any combination of pumping or tempering of rating factors necessary to achieve the order of importance required by section 1861.02(a). Because different insurers will use different rating factors and different methods for achieving compliance with the proposed regulations, it would be virtually impossible to perform a study which would show the precise effect that the proposed regulations will have upon premiums for Californians statewide. Generally speaking, the Commissioner's proposed regulations grant an insurer broad discretion to implement the proposed regulations, so long as a given insurer's rates assign the greatest weight to 1) driving safety record, followed by 2) annual miles driven, followed by 3) years of driving experience, followed by 4) any optional rating factors, weighted individually. While some studies have projected an average rate change for a particular region of the state, the impact of such projection upon a particular consumer will vary significantly due to the unique characteristics of each consumer. Additionally, to date, no study has explored all

of the possible methods by which any given insurer may choose to comply with the proposed regulations. For each of these reasons and others, any comment which suggests that premiums will raise or lower for a particular region of the state by an average of X% is purely speculative and fails to ignore the unique nature of each driver's characteristics as well as the unique manner in which each insurer will choose to comply with the regulations.

This comment includes a figure that suggests a particular County's drivers will receive rate increases of a particular size due to the Commissioner's regulations. To the extent that this comment is referring to the Mercer Actuarial Consulting, Inc. study, the figure appears to have been derived from "Instruction set 3" which was designed to replicate the results of a study performed by Robert Downer. As explained below, the Downer study does not represent an accurate portrayal of the impact of the proposed regulations on Californians' auto rates. Instruction sets 1 and 2, by comparison, showed substantially different and more favorable premium changes for good drivers in all regions of the state.

To the extent that this figure comes from a study produced by Robert Downer, it is important to note that the Downer study produced substantially flawed results which do not represent a reasonable projection of the way in which insurers will comply with the proposed regulations. The Downer study chose to diminish the effect of (i.e. – "temper") any optional factor that was greater than the factor of years of driving experience. At the same time, the Downer study did not permit the possibility of increasing the effect of (i.e. – "pumping") other factors, or a combination of diminishing some factors and increasing others. The proposed regulations, like the existing regulations, permit any insurer to pump or temper any rating factor as necessary in order to achieve compliance. This procedure was not implemented by Mr. Downer's study and directly resulted in the substantial premium shifting projected by Mr. Downer. The Downer study, in short, does not accurately reflect the manner in which insurers will implement the proposed regulations. Because the findings in the Downer study do not accurately reflect the manner in which insurers may implement the proposed regulations, they are irrelevant and consequently have been rejected by the Commissioner.

Mr. Downer's comments regarding the proposed regulations include a new study which he apparently performed in February of 2006. For the reasons described above, this study, like the Mercer data and Mr. Downer's previous study, are constrained by the same limitations and to a reasonable degree of certainty will not reflect the methods of pumping and tempering that individual insurers will use to comply with the proposed regulations.

1.5 Common Comments:

- **Seniors living in rural regions of the state should not be penalized by the proposed regulations.**

Response:

Proposition 103 provides that the number of years of driving experience must be the third most important rating factor, in terms of the weight given to each rating factor. Because

different insurers use differing characteristics to rate drivers according to their age and driving experience, whether a given consumer's age will result in a higher or lower auto insurance rate under the proposed regulations will largely depend upon which insurance company the consumer selects for coverage. Consumers who compare prices before purchasing automobile insurance may find that they will qualify for a lower insurance rate.

1.6 Common Comments:

- **The Downer Study and Instruction Set #3 from the Mercer Study suggest rates in my county will increase by X%.**

Response:

As with many of the figures cited in similar comments submitted to the Department, the figures cited in this comment do not bear a reasonable relationship to the likely rate impact of the proposed regulations. The percentage increase in rates described by this commenter appears to be based upon the results of the Downer study and the related results of Instruction set 3 from the Mercer Study. As explained in Response 1.4 above, the Downer study produced substantially flawed results, because Mr. Downer's analysis simply tempered the weight of the optional rating factors, without allowing for the pumping of mandatory factors. In other words, Mr. Downer's analysis sought to place the burden of the entire shift in a consumer's rate on territory without adjusting other rating factors to affect the rate. The Commissioner's regulations, however, do not condone such an approach. In fact, the Commissioner's regulations envision that insurers will do more than merely temper those factors, such as territory, which are weighted too heavily under Proposition 103. The Commissioner's regulations also seek to force insurers to pump, i.e. - give greater consideration to factors such as years licensed, annual mileage driven and driving safety record – factors that insurers have traditionally placed less emphasis on, when compared to the emphasis placed upon territory.

1.7 Common Comments:

- **The proposed regulations will produce rates which are not actuarially sound.**
- **The proposed regulations, by creating cross-subsidies, violate actuarial standards of practice.**
- **The proposed regulations are unfairly discriminatory or are not substantially related to the risk of loss because they are not actuarially sound.**

Response: As compared to the existing regulations, the Commissioner's proposed regulations represent the lawful interpretation of Proposition 103. Insurance Code section 1861.02 requires that every optional factor, such as territory, be given less weight than driving safety record, annual miles driven or years of driving experience. The American Academy of Actuaries' Statement of Principles for Risk Classification provides that actuarial standards must yield to social acceptability guidelines, including applicable law. (American Academy of Actuaries, Risk Classification Statement of Principles, p. 14, para. H.) Because optional factors must be given less weight than under the proposed

regulations in order to ensure that the mandatory factors are most important as section 1861.02 requires, the resulting rate cannot be considered actuarially unsound on this basis. Moreover, the Commissioner has observed substantial evidence to suggest that rates under the current regulatory system are often not tied to the risk of loss. Indeed, whether territory, gender, marital status or a multiple car discount are entitled to the significant weight they are given by many insurers under the existing regulations is a subject of considerable disagreement within the insurance ratemaking community.

1.8 Common Comments:

- **The proposed regulations violate *Spanish Speaking Citizens' Foundation v. Low*, because they allow for pumping and tempering.**
- **The proposed regulations violate *Spanish Speaking Citizens' Foundation v. Low*, because they create rates which are not based on the cost of providing insurance.**
- **The proposed regulations violate *Spanish Speaking Citizens' Foundation v. Low*, because rates which are not cost-based are arbitrary.**

Response: Although the Court in *Spanish Speaking Citizens* considered the standards of Proposition 103 and concluded that rates which deviated from cost-based pricing would violate Proposition 103's prohibition against arbitrary rates, the Court also conceded that "there may be no one single correct interpretation" of Proposition 103's competing requirements. (*Spanish Speaking Citizens' Foundation v. Low* 85 Cal.App.4th 1179, 1231.) The Court also acknowledged that the existing regulations do not ensure that rates will be determined primarily by driving safety record and mileage driven, as the ballot pamphlet to Proposition 103 intended. (*Spanish Speaking Citizens* 85 Cal.App.4th at 1237-38.) Recognizing the competing goals of Proposition 103, and the fact that rates are not determined primarily by driving safety record and mileage driven, the Court noted that an interpretation of Proposition 103 identical to the interpretation set forth in the Commissioner's proposed regulations, "may be a permissible interpretation of [section 1861.02]." (*Spanish Speaking Citizens* 85 Cal.App.4th at 1239.)

1.9 Common Comments:

- **The proposed regulations do not account for the likelihood of theft in urban areas versus rural areas**
- **The proposed regulations do not account for the likelihood of vandalism claims in urban areas versus rural areas.**

Response:

Claims for vehicle theft or vandalism generally fall under an insurance policy's comprehensive coverage. Claims under that coverage may have limited correlation to the mandatory rating factors. To the extent that comprehensive coverage bears less of a relationship to the mandatory factors of driving safety record, mileage driven and years of driving experience, the Commissioner has revised the regulations to account for the unique concerns raised by comprehensive coverage. Title 10 California Code of Regulations section 2632.8(a) permits an insurer to combine comprehensive coverage

with collision coverage to enhance the proposed regulations' substantial relationship to the risk of loss. The regulatory change which will allow such combination will comply with Proposition 103's weight ordering requirements insofar as comprehensive coverage and collision coverage represent a policy "combination thereof" as described in section 660(a).

Volume 5, Comment No. 1:

Commentator: Janine Gibford, Assistant Vice President, American Insurance Assoc.

Date of Comment: (None indicated)

Type of Comment: Written

Summary of Comment (pages 1-2): Proposed regulation results in rates/premiums that are inconsistent with the law. Regulation fails to cite Insurance Code section 1861.05 and regulation will result in arbitrary rates which are not actuarially sound. A change to the regulations without actuarial support is by definition "arbitrary" within the meaning of section 1861.05. Rates are not actuarially sound because optional rating factors such as territory will be given less weight, without evidence supporting the actuarial soundness of the result. Rates will be excessive for some, inadequate for others, and unfairly discriminatory for all. Because the Court in *Spanish Speaking Citizens Foundation v. Low* 85 Cal.App.4th 1179 concluded that territory is a more important determinant of the risk of loss than any other factor, the proposed regulations will violate section 1861.05.

Response to Comment:

See Response to Common Comment 1.1

See Response to Common Comment 1.7

See Response to Common Comment 1.8

Additional response:

Contrary to the commentator's suggestion, Insurance Code section 1861.05 is cited in the "reference" line of the proposed regulation text.

Summary of Comment (pages 3-4): Proposed regulations are against public policy. Regulations should not set rates on political considerations, but rather should be connected to the observed risks attendant to driving. Because the proposed regulations place restrictions upon the weight which may be given to certain factors which are tied to insurance risk, rates lose their connection to public policy concerns such as theft, fraud and deteriorating safety conditions within a particular region. The end result is to eliminate or diminish the incentive for public policymakers to work towards changing those conditions.

Response to Comment:

See Response to Common Comment 1.1

Additional response:

The proposed regulations do not set rates based upon political considerations. The regulations were drafted in order to bring rating factors into the order of importance envisioned by Proposition 103 and expressly stated in Insurance Code section 1861.02(a).

Rather than diminish the incentive for policymakers to work towards changing conditions in a particular region of the state, the proposed regulations will continue to provide ample incentive to both the driver of the vehicle as well as those who monitor the safety of roadways. Indeed, because driving safety record will be the most important characteristic, drivers will be given increased incentive to drive safely. Annual mileage, which will be the second most important characteristic, will reward drivers and roadways by encouraging Californians to avoid unnecessary mileage on roadways and through the conservation of gasoline. Finally, because location may be as high as the fourth-most important factor for auto insurance, policymakers still have a strong incentive to work on regional changes in driving conditions.

Volume 5, Comment No. 2:

Commentator: Robert Hogeboom, on behalf of The Alliance of Insurance Agents and Brokers.

Date of Comment: Jan. 11, 2006

Type of Comment: Written

Summary of Comment (pages 1-7): The proposed regulations will impact the insurance industry's practice of placing significant weight on the location of the driver's vehicle when determining automobile insurance rates. This is objectionable because the location of the insured vehicle has a significant relationship to the risk of loss and the proposed regulations limit insurers' ability to account for this relationship. *Spanish Speaking Citizens Foundation v. Low* concluded that, when evaluating the appropriateness of adjusting rating factor weights, the weights' "substantial relationship to the risk of loss" is a key factor that cannot be trumped by any other single consideration. The Court in *Spanish Speaking Citizens* concluded that a rate that is "unfairly discriminatory" within the meaning of section 1861.05 means that the rate is not substantially related to the risk of loss. The Court also determined that interpretations of the weight ordering requirement of section 1861.02 which preserved a substantial relationship to the risk of loss were favored. Interpretations which do not preserve this relationship would be arbitrary and therefore prohibited by Proposition 103. Whether the proposed regulations are lawful depends upon whether the regulations create rating factors that do not have a substantial relationship to the risk of loss or otherwise result in rates that do not reflect the cost of providing insurance – i.e. arbitrary rates.

Response to Comment:

See Response to Common Comment 1.1

See Response to Common Comment 1.8

Summary of Comment (pages 7-8): Proposition 103 was not intended to provide a subsidy so that the urban poor could have access to cheap insurance. Policy arguments which contend that the proposed regulations will aid the urban poor, therefore, are irrelevant. The Court in *Spanish Speaking Citizens* noted that Proposition 103, rather than designed to assist the urban poor, was designed to ensure that “good drivers throughout the state will pay less than they do now, while bad drivers will pay more.” The Court found that Proposition 103 was not intended to subsidize any particular class of drivers. The commentator concludes, therefore, that the *Spanish Speaking Citizens* decision establishes that, if actuarial analysis concludes that the proposed regulations will create an unfair subsidy, then the proposed regulations are invalid.

Response to Comment:

See Response to Common Comment 1.1
See Response to Common Comment 1.2
See Response to Common Comment 1.7
See Response to Common Comment 1.8

Additional response:

While the proposed regulations may provide some assistance to the urban poor, the primary purpose for drafting the proposed regulations was to bring the automobile rating factors into the correct order of importance described in section 1861.02(a).

Volume 5, Comment No. 3:

Commentator: Association of California Insurance Companies

Date of Comment: Jan. 12, 2006

Type of Comment: Written

Summary of Comment (page 1-2): A study performed by Mercer Actuarial Consulting, Inc. demonstrates that the proposed regulations will result in rate increases for the majority of drivers in the state, under each of the three instruction sets considered in the Mercer study. The instruction sets included two scenarios under which primary factors were pumped, but even under these scenarios the majority of drivers experienced rate increases. A study performed by Robert Downer reached a similar conclusion, under conditions which assume that an insurer tempered the optional rating factors, without pumping any mandatory factors.

Response to Comment:

See Response to Common Comment 1.4
See Response to Common Comment 1.6

Summary of Comment (page 2): Insurance rates must be based upon the risk of loss. By forcing insurers to pump or temper rating factors, the proposed regulations will move rates away from risk-based rates. *Spanish Speaking Citizens Foundation v. Low* concluded that rates must not be arbitrary. The proposed regulations are unlawful because they will result in arbitrary (i.e.-non-risk based) rates.

Response to Comment:

See Response to Common Comment 1.1

See Response to Common Comment 1.7

See Response to Common Comment 1.8

Summary of Comment (page 2-3): The proposed regulations present significant issues, concerning implementation. Insurers must be given sufficient time to develop, test and file class plans with the Commissioner, and a July 1, 2006 filing date is impractical and unreasonable. Instead, insurers should be given four years to implement the proposed regulations, under a system which provides a great degree of flexibility to individual insurers to decide upon the best implementation approach for that insurer. The proposed regulations will require insurers to assign greater weight to the annual mileage driven rating factor. Therefore, the Department should undertake legislative and regulatory steps to give insurers sufficient tools to verify mileage.

Response to Comment:

The Commissioner does not intend to require rates to be filed by July 1, 2006. The Commissioner has taken similar insurer input into account and has decided upon a reasonable schedule for implementation which will give insurers flexibility to decide upon the best approach for implementation, but will also ensure that compliance is achieved in a timely manner. Therefore, while the Commissioner believes that four years is too much time to implement the proposed regulations, he has revised the regulations to provide for a two-year schedule. This schedule also provides that insurers must bring their rates at least 15% of the way towards full compliance with the proposed regulations in the first class plan filing, but gives insurers discretion to implement the remaining 85%, so long as the implementation is completed by the two year anniversary of the date the regulations are filed with the Secretary of State. See revisions to 10 Cal. Code of Regulations section 2632.11.

With respect to the suggestion for better methods to verify mileage, while it may be possible to develop methods for enhancing an insurers' ability to verify annual mileage or other rating factors, such proposals are beyond the scope of this rulemaking proceeding.

Volume 5, Comment No. 4:

Commentator: Keesha-Lu Mitra, on behalf of State Farm Ins. Co.

Date of Comment: Jan. 10, 2006

Type of Comment: Written

Summary of Comment (page 1-2): The law requires fair and non-arbitrary rates, which means that rates must be based on the cost of providing the insurance. The practice of pumping and tempering of specific rating factors, by definition, will sever the rates from cost-based rating. Because the proposed regulations may require pumping and tempering of rates, insurers may be compelled to charge rates that do not accurately reflect the risk of loss, which would be an unlawful result. The proposed regulations are not necessary in order to comply with the law, because the court in *Spanish Speaking Citizens Foundation v. Low* concluded that the existing regulations comply with Insurance Code section 1861.02(a).

Response to Comment:

See Response to Common Comment 1.1

See Response to Common Comment 1.8

Summary of Comment (page 2): The regulations are unclear as to whether or not insurers will be permitted to both pump and temper rating factors, and whether insurers may use a combination of pumping and tempering for either the mandatory or the optional rating factors. The commentator suggests that, if insurers are going to be given authority to do either, the regulations should be revised to clarify this change.

Response to Comment:

The Commissioner's proposed regulations, like the existing regulations, were intended to permit either pumping or tempering, as necessary in order to bring the rating factors into proper alignment. In order to make this intention clearer, the proposed regulations have been revised. Specifically, the Commissioner has added section subdivision (d)(4) to section 2632.8 of title 10 of the California Code of Regulations to make this clear.

Summary of Comment (page 3-4): If the proposed regulations intend to permit insurers to pump or temper rating factors, as well as use a combination of pumping and tempering, then the analysis performed by Mercer Actuarial Consulting, Inc. does not address this approach. Moreover, the Mercer data only addresses the effect of the proposed regulations upon bodily injury and property damage coverages. Additional studies should, therefore, be conducted before the proposed regulations take effect.

Response to Comment:

The Commissioner disagrees with the suggestion that the Mercer data do not reflect combinations of pumping and tempering. The Mercer data instruction sets 1 and 2 did include two possible combinations of pumping and tempering that could be used by insurers, however, the proposed regulations give insurers significant discretion to apply an approach that makes the most sense for that insurer. The proposed regulations have

been the subject of extensive study. There is no study that could be performed which could capture the many different combinations of pumping and tempering that individual insurers may elect to utilize, and subsequently adjust in future class plan filings, in order to comply with the proposed regulations.

Summary of Comment (page 4): The proposed regulations still require that rating factor weights be calculated for each type of coverage. This will result in unfair rate changes because some rating factors are not predictive of the risk of loss for certain coverages. Comprehensive coverage and its relationship to annual mileage driven presents an example of a coverage with no relationship to the risk of loss. Therefore, the proposed regulations should only be applied to the bodily injury and property damage coverages.

Response to Comment:

The Commissioner believes that the effect of the proposed regulations upon the bodily injury and property damage coverages will be substantially similar to the effect the proposed regulations will have on other coverages. To the extent that comprehensive coverage bears less of a relationship to the mandatory factors of driving safety record, mileage driven and years of driving experience, the Commissioner has revised the regulations to account for the unique concerns raised by comprehensive coverage. Title 10 California Code of Regulations section 2632.8(a) permits an insurer to combine comprehensive coverage with collision coverage to enhance the proposed regulations' substantial relationship to the risk of loss.

Summary of Comment (page 4): The Commissioner should make additional changes to the rating factor regulations which will affect the ultimate impact of the proposed regulations on California policyholders. The Commissioner should expressly provide for an insurer's ability to verify annual miles driven by giving insurers stronger methods of verifying odometer readings.

Response to Comment:

While it may be possible to develop methods for enhancing an insurers' ability to verify annual mileage or other rating factors, such proposals are beyond the scope of this rulemaking proceeding.

Summary of Comment (page 5): The Commissioner should eliminate the provision of the existing regulations which prohibits insurers from using more than 10 zip code rating bands for frequency of vehicle loss claims and 10 bands for the severity of vehicle loss claims. By eliminating these bands, insurers will be able to place risks directly with the risk of loss without being forced to make an arbitrary selection of particular bands for particular risks.

Response to Comment:

While the Commissioner does not believe it would be appropriate to eliminate the zip code rating bands, the Commissioner does agree that the number of bands should be increased in order to minimize the amount of disparity between rates for adjoining zip codes. Thus, while the existing regulations permit up to 100 zip code groupings (10 frequency bands x 10 severity bands), the Commissioner has revised the regulations so that insurers may utilize up to 400 zip code groupings (20 frequency bands x 20 severity bands). This change is reflected in 10 California Code of Regulations section 2632.5(d) (15) & (16) of the revised draft of the proposed regulations.

Volume 5, Comment No. 5:

Commentator: Keesha-Lu Mitra, on behalf of State Farm Ins. Co.

Date of Comment: Feb. 23, 2006

Type of Comment: Written

Summary of Comment (page 1): The law requires fair and non-arbitrary rates, which means that rates must be based on the cost of providing the insurance. The practice of pumping and tempering of specific rating factors, by definition, will sever the rates from cost-based rating. Because the proposed regulations may require pumping and tempering of rates, insurers may be compelled to charge rates that do not accurately reflect the risk of loss, which would be an unlawful result. The proposed regulations are not necessary in order to comply with the law, because the court in *Spanish Speaking Citizens Foundation v. Low* concluded that the existing regulations comply with Insurance Code section 1861.02(a).

Response to Comment:

See Response to Common Comment 1.1

See Response to Common Comment 1.8

Summary of Comment (page 2-3): The regulations are unclear as to whether or not insurers will be permitted to both pump and temper rating factors, and whether insurers may use a combination of pumping and tempering for either the mandatory or the optional rating factors. The commentator suggests that, if insurers are going to be given authority to do either, the regulations should be revised to clarify this change. The commentator has attached draft language that it submits will clarify that insurers may employ a combination of approaches to pump or temper rating factors. The draft language also removes what the commentator describes as an “unnecessary” restriction to a .25 difference between successive rating factors, which makes compliance more difficult.

Response to Comment:

The Commissioner's proposed regulations, like the existing regulations, were intended to permit either pumping or tempering, as necessary in order to bring the rating factors into proper alignment. In order to make this intention clearer, the proposed regulations have been revised. Specifically, the Commissioner has added section subdivision (d)(4) to section 2632.8 of title 10 of the California Code of Regulations to make this clear. While the revised language in subdivision (d)(4) is not identical to the language proposed by

this commentator, the effect will be the same: insurers may either pump or temper rating factors in order to bring the rating factors into proper alignment. With respect to the proposal to delete the requirement that insurers must ensure a .25 difference between successive rating factors, the Commissioner respectfully declines. The requirement that the weight of a corrected rating factor may not exceed the corrected weight of the succeeding factor by more than 0.25 ensures that insurers do not over-correct rating factors. The Commissioner, therefore, intends to preserve this requirement within the regulations.

Summary of Comment (page 3): The commentator has attached a proposed change to the regulations, which would specify that the proposed regulations will not prohibit other class plan changes that may affect the initial rating factor weights. The commentator provides, as an example, the assumption that the proposed change will allow insurers to change the use of gender and/or marital status in conjunction with years of driving experience, despite the fact that the change would affect the initial weights.

Response to Comment:

The Commissioner respectfully declines this proposal. Contrary to the assumption in this comment, when an insurer combines years of driving experience with a rating factor such as gender or marital status, the Commissioner expects that the weights of those factors, taken individually, will comply with the weight ordering requirements of the regulations. The Commissioner has revised 10 California Code of Regulations section 2632.5(e) of the proposed regulations to make this clear.

Summary of Comment (page 3-6): The commentator contends that the proposed regulations do not assess the indirect economic impact upon California individuals, thereby violating Government Code section 11346.3(a). The commentator submits, therefore, that there is need for further study to determine the financial impact on California consumers.

If the proposed regulations intend to permit insurers to pump as well as temper rating factors, as well as use a combination of pumping and tempering, then the analysis performed by Mercer Actuarial Consulting, Inc. does not address this approach. Moreover, the Mercer data only addresses the effect of the proposed regulations upon bodily injury and property damage coverages. The commentator further submits that the Mercer data required insurers to apply the third mandatory factor of years licensed by itself, and without combination with other rating factors. Because, under the existing regulations, many insurers combine years licensed with factors such as gender and marital status, the Mercer study does not reflect what insurers are likely to do to comply with the proposed regulations. Additional studies should, therefore, be conducted before the proposed regulations take effect.

Response to Comment:

The Commissioner disagrees with the suggestion that the Mercer data do not reflect combinations of pumping and tempering. The Mercer data instruction sets 1 and 2 did include two possible combinations of pumping and tempering that could be used by

insurers, however, the proposed regulations give insurers significant discretion to apply an approach that makes the most sense for that insurer. The proposed regulations have been the subject of extensive study. There is no study that could be performed which could capture the many different combinations of pumping and tempering that individual insurers may elect to utilize, and subsequently adjust in future class plan filings, in order to comply with the proposed regulations. Nor would it be prudent, given the extent of technical discussion regarding the proposed regulations to date, to perform additional studies to assess the many different ways that individual insurers combine years licensed with factors such as gender and marital status.

While the Commissioner has performed an assessment of the economic impact on California business enterprises and individuals in accordance with Government Code section 11346.3, the Commissioner is also cognizant of the limitations inherent with respect to such assessment, due to the complexity of insurance ratemaking. The Commissioner is confident that his assessment of the impact upon businesses and individuals is more than adequate, given the limitations of such assessment due to the constant evolution of individual insurers' class plans. The Commissioner's assessment recognizes that some degree of uncertainty will necessarily persist, due to the degree of flexibility that insurers are given in their class plan filings in order to comply with the proposed regulations, in addition to the adjustments which individual insurers will necessarily make to their class plans as they calibrate their rates to comply with the proposed regulations. It is highly doubtful that further study would bring further clarity to the effect of the proposed regulations. At best, it is likely that further study would only reconfirm an assessment the Commissioner has already made. At worst, it would unnecessarily delay the Commissioner's efforts to complete this rulemaking proceeding that has been the subject of a pending petition for rulemaking since 2003.

Summary of Comment (page 3, 6-8): The proposed regulations still require that rating factor weights be calculated for each type of coverage. This will result in unfair rate changes because some rating factors are not predictive of the risk of loss for certain coverages. Comprehensive coverage and its lack of correlation to annual mileage driven presents an example of a coverage with no relationship to the risk of loss. The commentator believes that section 1861.02(a) is ambiguous insofar as it refers to “[r]ates and premiums for an automobile policy, as described in subdivision (a) of Section 660”. Because policyholders may elect to purchase or not purchase some optional coverages, the commentator reads “policy” under section 660 as only referring to the coverages required by law, such as property damage and bodily injury coverage. Therefore, the proposed regulations should only be applied to the bodily injury and property damage coverages. The proposed regulations will not be substantially related to the risk of loss, will be arbitrary, and therefore will violate the *Spanish Speaking Citizens* case, in the event that the regulations require insurers to apply the weight ordering requirement to coverages like comprehensive coverage. The commentator has submitted proposed draft language as attachment 1. The draft language would specify that the weight ordering requirement of the proposed regulations will apply to the bodily injury and property damage coverages alone, rather than to all coverages.

Response to Comment:

See Response to Common Comment 1.1

See Response to Common Comment 1.8

The Commissioner respectfully declines the language proposed by the commentator. Insurance Code section 1861.02(a) provides that "automobile insurance policy" has the meaning described in Insurance Code section 660(a). Section 660(a) provides that a "policy" means an automobile liability policy, automobile physical damage, or automobile collision policy, or any combination thereof..." Section 660(c) defines physical damage coverage as including "loss or damage to an automobile insured ... except loss or damage resulting from collision or upset." Insurance Code section 11580.07 defines comprehensive coverage as "coverage for loss or damage...resulting from a cause other than collision or upset." Thus, the plain reading of the statutes requires that comprehensive coverage, or a combination of comprehensive coverage and other coverages, must comply with the weight ordering requirements of Proposition 103. Based upon the plain meaning of this provision, therefore, the Commissioner disagrees with the commentator's suggestion that 1861.02(a) should only apply to property damage and bodily injury coverages.

The Commissioner believes that the effect of the proposed regulations upon the bodily injury and property damage coverages will be substantially similar to the effect the proposed regulations will have on other coverages. To the extent that comprehensive coverage bears less of a relationship to the mandatory factors of driving safety record, mileage driven and years of driving experience, the Commissioner has revised the regulations to account for the unique concerns raised by comprehensive coverage. The revision to title 10 California Code of Regulations section 2632.8(a) permits an insurer to combine comprehensive coverage with collision coverage to enhance the proposed regulations' substantial relationship to the risk of loss. The regulatory change which will allow such combination will comply with Proposition 103's weight ordering requirements insofar as comprehensive coverage and collision coverage represent a policy "combination thereof" as described in section 660(a).

Summary of Comment (page 8): The Commissioner should make additional changes to the rating factor regulations which will affect the ultimate impact of the proposed regulations on California policyholders. The Commissioner should expressly provide for an insurer's ability to verify annual miles driven by giving insurers stronger methods of verifying odometer readings. More accurate and reliable means of classifying risks for annual mileage should be explored by the Commissioner and implemented.

Similar to the consequences of pumping annual mileage caused by the proposed regulations, there will be consequences to pumping driving safety record. The commentator recommends that the Commissioner should revisit 10 Cal. Code of Regulations section 2632.13(i) and the provision which allows a policyholder to self-certify his or her accident history. This provision should be revisited because of the

commentator's fear that some policyholders are not accurately reporting their accident histories.

Response to Comment:

While it may be possible to develop methods for enhancing an insurers' ability to verify annual mileage, driving safety record, or other rating factors, such proposals are beyond the scope of this rulemaking proceeding.

Summary of Comment (page 10): The Commissioner should eliminate the provision of the existing regulations which prohibits insurers from using more than 10 zip code rating bands for frequency of vehicle loss claims and 10 bands for the severity of vehicle loss claims. By eliminating these bands, insurers will be able to place risks directly with the risk of loss without being forced to make an arbitrary selection of particular bands for particular risks.

Response to Comment:

While the Commissioner does not believe it would be appropriate to eliminate the zip code rating bands, the Commissioner does agree that the number of bands should be increased in order to minimize the amount of disparity between rates for adjoining zip codes. Thus, while the existing regulations permit up to 100 zip code groupings (10 frequency bands x 10 severity bands), the Commissioner has revised the regulations so that insurers may utilize up to 400 zip code groupings (20 frequency bands x 20 severity bands). This change is reflected in 10 California Code of Regulations section 2632.5(d) (15) & (16) of the revised draft of the proposed regulations.

Volume 5, Comment No. 6:

Commentator: Jay Hieb, on behalf of State Farm Ins. Co.

Date of Comment: Stamped received by the Department on March 6, 2006

Type of Comment: Written

Summary of Comment (page 1-4): The commentator has conducted its own study to evaluate the effect of compliance with the Commissioner's proposed regulations. The commentator's results of that study are attached as Exhibit 1 to his comments. The proposed regulations will result in rates that are arbitrary, unfairly discriminatory and not substantially related to the risk of loss. By contrast, the commentator contends, no party has demonstrated that the existing regulations result in arbitrary rates which are not substantially related to the risk of loss.

By anchoring price to the risk of loss, insurers can ensure that rates comply with sections 1861.02(a) and 1861.05 and the requirement that rates must remain substantially related to the risk of loss and cannot be unfairly discriminatory.

The concerns raised by the parties who petitioned for this rulemaking proceeding have focused upon the difference in premium paid by one group of consumers versus another group that falls within a particular category of claims cost and claims frequency rating factor bands. These concerns, however, do not have anything to do with the weight assigned to a particular rating factor.

Response to Comment:

See Response to Common Comment 1.1

See Response to Common Comment 1.7

Additional comment:

While the difference in premium between adjoining zip codes is not entirely caused by the influence of territory upon rates under the existing regulations, the magnitude of the premium disparity is certainly related to the weight assigned to territory under the existing regulations. The proposed regulations will reduce the disparity across zip code boundaries in two ways. First, by ensuring that territory cannot have greater significance than driving safety record, annual miles driven and years of driving experience, territory's influence upon premium may be reduced for some insurers. Second, the Commissioner has increased the number of zip code groupings in order to reduce the premium disparity across zip codes. Specifically, the Commissioner has revised the regulations so that insurers may utilize up to 400 zip code groupings (20 frequency bands x 20 severity bands). This change is reflected in 10 California Code of Regulations section 2632.5(d) (15) & (16) of the revised draft of the proposed regulations.

Summary of Comment (page 4-5):

Driving safety record is already the primary factor used in determining insurance rates in California, by many measures. The first measure: driving safety record is the first factor analyzed under the sequential analysis method required by 10 Cal. Code of Regulations section 2632.7. To the extent that the cost of a particular factor being considered is tied to and can be explained by other factors, the cost explained by other factors is removed in the analysis of each subsequent factor. The commentator provides an example of the sequential analysis employed by commentator's insurer in Exhibit 2. The second measure: for the commentator's book of business, an adult driver's rate increases more from an accident involving bodily injury liability than from moving from one ZIP code to a contiguous ZIP code. Therefore, a consumer's rate increases more based on the accident than on the move to a contiguous ZIP code.

Response to Comment:

This comment is essentially a restatement of the Court of Appeal decision in *Spanish Speaking Citizens' Foundation v. Low* (2000) 85 Cal.App.4th 1179. As the Court of Appeal acknowledged: "The regulations' provisions for sequential analysis ensure that mandatory factors will be considered 'first' in determining premiums, and that those factors will account for all of the risks of loss they represent. What the regulations do not do is ensure that rates will be determined primarily by driving safety record and mileage

driven." (*Id.* at p. 1238.) An interpretation of Proposition 103 that does not ensure that driving safety record, annual miles driven and years of driving experience are the most important factors for determining rates and premiums is an interpretation that does not properly comply with Insurance Code section 1861.02(a). Other measures which fail to ensure that driving safety record, annual miles driven and years of driving experience carry the most weight are inapposite. It is for this reason that the Commissioner has proposed these regulations.

Summary of Comment (page 6): The proposed regulations propose to make “‘how you drive’ more influential on premium than ‘where you live.’” With respect to two examples considered by the commentator, where the driver lives will impact rates more than the driver’s safety record. For instance, the commentator contends that the rates for a driver with 34-48 years of driving experience will go up in over 60% of the ZIP codes if the commentator purely tempers the optional rating factors to achieve compliance. In another example, the commentator found that the same drivers’ rates would go up for 1/3rd of the ZIP codes if the commentator were to split the adjustment 50/50 between pumping and tempering, in order to comply with the proposed regulations.

Response to Comment:

Exercises which seek to purely temper the optional rating factors, but do not pump the mandatory factors are similar to the Downer analysis. Because the Commissioner has identified instruction set 3 from the Mercer data and the Downer analysis as a method that insurers are very unlikely to use, the results of such study are virtually useless. Similarly, while the Commissioner expects that insurers may employ a combination of pumping and tempering of factors in order to achieve compliance with the proposed regulations, it is unlikely that an insurer would use a method similar to that used by the commentator. Thus, for the same reasons that the Mercer data and Downer analysis have limited predictive ability, the commentator's study cannot be said to reflect the true rates which the commentator's policyholders will observe when insurers comply with the proposed regulations. Insofar as section 1861.02 requires rates to be based primarily upon how you drive rather than where you live, the proposed regulations seek to implement the will of the voters in enacting Proposition 103.

Summary of Comment (page 6-7): The only way to truly make driving safety record more influential for premium would be to give insurers stronger methods to ascertain driving safety record. Because 10 Cal. Code of Regulations section 2632.13(i) requires an insurer to accept an applicants’ self-verification of accident record, the insurer cannot obtain independent support. Additionally, because drivers are permitted to have traffic citations expunged from their records by attending traffic school, under certain circumstances, insurers are prevented from obtaining a fully accurate assessment of its policyholders’ driving safety records.

Response to Comment:

While it may be possible to develop methods for enhancing an insurers' ability to verify annual mileage, driving safety record, or other rating factors, such proposals are beyond the scope of this rulemaking proceeding.

Moreover, to the extent that the commentator objects to state laws which permit a policyholder to have tickets expunged from his/her record through traffic school, the objections are misplaced. The Legislature alone has the power to determine the circumstances under which public policy should permit a driver to have a citation expunged. Such concerns are best placed before the Legislature – not the Commissioner.

In footnote 2 of page 6 of the commentator's remarks, the commentator concedes, as he must, that the insurer is entitled to consider information from an independent source to verify information provided by a policyholder concerning accident history. Thus, it is incorrect to say that an insurer cannot obtain independent support. In fact, whether an insurer obtains independent support for a policyholder's accident history verification is primarily a business decision. To the extent that an insurer would like to enhance the accuracy of its assessment of driving safety record for its policyholders, the insurer has the option to avail itself of resources such as a CLUE database or similar accident tracking system.

Summary of Comment (page 7-9): Most, if not all, insurers will be required to change rating factor weights for reasons that are not related to cost-based pricing, if the proposed regulations take effect. Pumping and tempering, by definition, moves rating factor relativities away from cost-based pricing. While the Commissioner is correct that selecting a specific pump/temper combination will have a different effect on the groups of policyholders effected and therefore will have a different effect on rates, the nature of the impact is the same insofar as some policyholders will pay more while others will pay less. The change in which policyholder will pay more or less will not be related to any changes in the risk of loss that each policyholder represents. This is particularly true for comprehensive coverage rates. The fact that certain groups may be impacted by a selected compliance methodology, versus another selected compliance methodology does not change the fact that the rate changes are arbitrary.

Response to Comment:

See Response to Common Comment 1.1

See Response to Common Comment 1.7

See Response to Common Comment 1.8

Additional Response:

The Commissioner believes that the effect of the proposed regulations upon the bodily injury and property damage coverages will be substantially similar to the effect the proposed regulations will have on other coverages. To the extent that comprehensive coverage bears less of a relationship to the mandatory factors of driving safety record, mileage driven and years of driving experience, the Commissioner has revised the regulations to account for the unique concerns raised by comprehensive coverage. The

revision to title 10 California Code of Regulations section 2632.8(a) permits an insurer to combine comprehensive coverage with collision coverage to enhance the proposed regulations' substantial relationship to the risk of loss. The regulatory change which will allow such combination will comply with Proposition 103's weight ordering requirements insofar as comprehensive coverage and collision coverage represent a policy "combination thereof" as described in section 660(a).

Summary of Comment (page 9-10): Some have argued that the restrictions on territorial rating used in Connecticut support the Commissioner's proposed regulations. The restrictions in Connecticut are different than those in the proposed regulations, and Connecticut's characteristics do not make it a good example for California.

Response to Comment:

The proposed regulations do not rely, in whole or in part, upon the experience of territorial rating restrictions in Connecticut. The proposed regulations are designed to properly implement the requirements of Proposition 103, as adopted by the California voters.

Summary of Comment (page 10):

The commentator disagrees with the claim that because similarly situated policyholders often see substantial rate differences when compared to neighboring ZIP codes or similar territory regions, that rates are arbitrary under the existing regulations. The commentator contends that because rates are filed with and approved by the Department of Insurance, any rates which are not actuarially justified under the existing regulations would not be approved by the Department.

Response to Comment:

Insurers are often permitted to implement rates that deviate from cost-based rating. For example, despite the fact that a given insurer may have an indicated rate relativity based upon the insurer's loss experience, insurers often select different rate relativities. The reasons for these selections often vary and may include considerations not related to cost-based pricing, such as marketing. The Department of Insurance constantly grapples with the conflicting demands of ensuring that rates are not unfairly discriminatory, while still permitting insurers flexibility in ratemaking judgment within the confines of section 1861.05. Any suggestion that cost-based rating is mandated without exception simply ignores reality.

See also Response to Common Comment 1.1.

Summary of Comment (page 10-12): The Commissioner should eliminate the provision of the existing regulations which prohibits insurers from using more than 10 zip code rating bands for frequency of vehicle loss claims and 10 bands for the severity of vehicle loss claims. The commentator provides an example of the distribution of ZIP codes under the current rating bands for the commentator's insurance company. By eliminating these bands, insurers will be able to place risks directly with the risk of loss without being

forced to make an arbitrary selection of particular bands for particular risks. By allowing insurers to set their own territory definitions, it will be possible to reduce the disparity observed today between ZIP code boundaries.

Response to Comment:

While the Commissioner does not believe it would be appropriate to eliminate the zip code rating bands, the Commissioner does agree that the number of bands should be increased in order to minimize the amount of disparity between rates for adjoining zip codes. Thus, while the existing regulations permit up to 100 zip code groupings (10 frequency bands x 10 severity bands), the Commissioner has revised the regulations so that insurers may utilize up to 400 zip code groupings (20 frequency bands x 20 severity bands). This change is reflected in 10 California Code of Regulations section 2632.5(d) (15) & (16) of the revised draft of the proposed regulations.

Summary of Comment (page 12-13): Contrary to Petitioners' arguments, claims frequency and claims severity should be used as rating factors. Exhibit 4 to the commentator's remarks reflects a study which confirms the widespread differential in loss costs between different geographic regions of the state. The commentator also responds to an argument raised by Petitioners concerning whether a suburban commuter who drives into an urban center should pay higher rates than an urban commuter that drives to a suburban locale. The commentator provides Exhibit 5, which represents a study that found the majority of accidents occur within less than 10 miles of home.

Response to Comment:

These comments are directed at Petitioners' remarks. The proposed regulations do not propose to eliminate claims frequency or severity as rating factors. The proposed regulations also do not seek to place particular restrictions upon the rates for suburban drivers commuting into urban centers or vice-versa. In light of the above, the comments are not specifically directed at the agency's proposed action or the procedures followed by the Department in proposing the action, they do not require a response.

Summary of Comment (page 13):

Petitioners have presented charts showing that the commentator's insurer assigns more weight to gender/marital status than to any other rating factor. The commentator responds to those comments by pointing out that the gender/marital status factor is combined with years licensed, and in most cases affects drivers with less than 9 years of driving experience. Moreover, if the factors were calculated separately for gender, marital status and years licensed, the weights would be significantly less.

Response to Comment:

These comments are directed at Petitioners' remarks. To the extent that the comments are not specifically directed at the agency's proposed action or the procedures followed by the Department in proposing the action, they do not require a response.

Additional response:

While the Commissioner agrees that gender and marital status are often given too much influence under the existing regulations, the proposed regulations will ensure that no factor, considered on an individual basis can weigh more than years licensed, as required by Proposition 103.

Volume 5, Comment No. 8:

Commentator: Hilary Rowen, on behalf of the California Farm Bureau Federation

Date of Comment: Stamped received by the Department on March 6, 2006

Type of Comment: Written

Summary of Comment (page 1-12 & Appendices A, B & C): Except as otherwise summarized below, these pages provide a general summary of the commentator's background and experiences as well as other background information related to the proposed regulations.

Response to Comment: Because this portion of the comment is not specifically directed at the Commissioner's proposed regulations or to the procedures followed in proposing the regulations, no response is necessary. (Gov. Code section 11346.9.)

Summary of Comment (page 6): The third mandatory factor of years of driving experience is a relatively weak predictor of the likelihood of being in an accident for the vast majority of drivers –especially when compared to the rating factors relating to where a driver predominantly drives.

Response to Comment:

While the commentator contends that the factor of years of driving experience is a relatively weak predictor of the likelihood of being in an accident, the commentator provides no empirical support for this proposition. In any event, the proposed regulations seek to implement section 1861.02(a) which requires that years of driving experience must be the third most important factor for calculating automobile insurance rates. Despite the commentator's assertions to the contrary, a driver's location cannot be assigned greater importance.

See also Response to Common Comment 1.1

Summary of Comment (page 8-10): Because of the magnitude of pumping and tempering of the rating factors, instruction sets 1-3 of the Mercer study indicate that the proposed regulations will give weights to the mandatory factors that exceed the risk of loss for bodily injury coverage, and give weights to the optional territory factors that are lower than the expected risk of bodily injury liability loss. Thus, the commentator concludes that the proposed regulations give excessive weight to the mandatory factors and force insurers to price the optional territory factors for bodily injury coverage below the actual risk of loss, as shown by the underlying loss data for a given insurer. The commentator believes that instruction set 3 demonstrates the clearest perspective on the

degree to which the proposed regulations will move the optional territory factors away from the level indicated by those factors' underlying loss data.

Response to Comment:

See Response to Common Comment 1.1

See Response to Common Comment 1.4

See Response to Common Comment 1.6

See Response to Common Comment 1.7

Summary of Comment (page 11, 13-16 & exhibits 1&2): While the Mercer study instruction sets are not likely to be identical to the rate increases and decreases that insurers will file to comply with the proposed regulations, the general direction of the rate changes shown in the Mercer study will be the same as the rate changes which will occur when insurers implement the regulations. Thus, rates will go up in urban areas and down in rural areas. Premiums will move away from the cost of claims and the burden of the rate increases will fall disproportionately on drivers with below-average incomes, while the benefits will fall on drivers with above-average incomes. The Mercer study shows average premium change, so within a given region, individual rate changes will be smaller or larger than the average. What is less certain is the magnitude of these effects, when insurers implement the proposed regulations.

Response to Comment:

See Response to Common Comment 1.1

See Response to Common Comment 1.2

See Response to Common Comment 1.3

See Response to Common Comment 1.4

Additional Response:

The Commissioner agrees that the magnitude of the effects of the proposed regulations will not be fully known until insurers have filed class plans which implement the proposed regulations.

Summary of Comment (page 16-18 & exhibits 1, 2,3):

The commentator compared the Mercer data with pure premium data from the California Automobile Assigned Risk Plan. Based upon this comparison, the commentator concludes that the proposed regulations will produce rates wherein drivers with higher claim costs will receive rate decreases, while drivers with lower claim costs will receive rate increases. These changes will create cross-subsidies that are not related to the cost of insurance claims.

Response to Comment:

See Response to Common Comment 1.1

See Response to Common Comment 1.4

Summary of Comment (page 18-21): The Commentator performed a study designed to address the argument that the proposed modifications to the regulations, while creating premium disruption, could still be moving premiums closer to cost-based pricing. This study is performed by comparing the California Automobile Assigned Risk Plan data to the results of Mercer instruction sets 1, 2 and 3. The study assumes that the CAARP data provides a solid measure of the frequency and cost of insurance claims by ZIP code. A comparison of the CAARP pure premium data versus the current premium data shows a correlation of 1 (pure premium) to 0.751 or 0.793 (current premium data), depending upon the coefficient test used. The closer the correlation is to 1, the better the correlation. For instruction set 1, the correlation drops to 1 (pure premium) to 0.725 or 0.744, depending upon the coefficient test used. For instruction set 2, the correlation drops to 1 (pure premium) to 0.731 or 0.793, depending upon the coefficient test. For instruction set 3, the correlation drops to 0.618 or 0.604, depending upon the coefficient test. Thus, instruction set three shows the poorest relationship to the actual loss costs among the items compared. The commentator concludes that the correlation between the pure premiums and current premiums demonstrates that they are “reasonably correlated” with the costs of insurance claims, while the correlation between the pure premiums and Mercer instruction sets are “significantly more poorly correlated with the cost of insurance claims.” The commentator concludes that the proposed regulations will not reflect true expected losses.

Response to Comment:

See Response to Common Comment 1.1

Additional Response:

The commentator's study shows reinforces three points: 1) the existing regulations do not result in purely cost-based rates, but because they still bear a relatively strong correlation to pure premium, they are substantially related to the risk of loss. 2) although the study suggests that the proposed regulations will be slightly less correlated to the risk of loss when compared to the existing regulations, the proposed regulations will still result in rates that are substantially related to the risk of loss. 3) instruction set 3, which is virtually identical to the Downer study performed in 2003, is the least correlated to cost-based pricing, and it is highly unlikely that insurers would attempt to comply with the proposed regulations by using the Downer approach.

The commentator's study reaffirms that the proposed regulations can be implemented in a manner which permits rates to be substantially related to the risk of loss, while at the same time preserving the requirement of Insurance Code section 1861.02 that driving safety record, annual miles driven and years of driving experience must be more important than territory.

Summary of Comment (page 22-23): Insurance Code section 1861.05 prohibits rates which “inflate premiums for one group of policyholders in order to depress premiums for

another group of policyholders. A systematic pattern of under-charges and over-charges generates inadequate premiums for some policyholders and excessive premiums for other policyholders. The proposed regulations will create excessive rates for rural and suburban policyholders while creating inadequate rates for urban policyholders. Insurance Code section 1861.02's requirement that the rating factors be aligned in "decreasing order of importance" does not expressly require that the weight of the mandatory factors be given greater weight than the optional factors. "Order of importance" should be read to mean that the mandatory factors should be given the maximum weight the data will allow, but should not be artificially inflated. By artificially inflating or diminishing particular rating factors, the proposed regulations will create cross-subsidies that section 1861.02 should not be construed to allow.

Response to Comment:

See Response to Common Comment 1.1

See Response to Common Comment 1.7

Additional Response:

Contrary to the commentator's suggestion, section 1861.02 does require that the mandatory factors be given greater weight than the optional factors. Not only is this clear from the requirement that the mandatory factors must be at the top of the order of "importance" as provided in section 1861.02, it is also clear from the statements in the ballot pamphlet which provide that ""In general, the measure requires that rates and premiums for automobile insurance be determined on the basis of the insured person's driving record, miles driven and number of years of driving experience."

Indeed, even the Court of Appeal acknowledged that section 1861.02 intended rates to be determined primarily by driving safety record, when the Court stated: "[w]hat the regulations do not do is ensure that rates will be determined primarily by driving safety record and mileage driven. But as Judge Vogel put it when she looked at this problem over a decade ago, because '[t]his is not a perfect world and Proposition 103 is not a perfect system,' the Commissioner is left to 'choose [among] imperfect results.'" *Spanish Speaking Citizens' Foundation v. Low* (2000) 85 Cal. App. 4th 1179, 1238.)

The Commissioner cannot conceive of a proper implementation of Proposition 103 and Insurance Code section 1861.02 which does not ensure that the mandatory factors are given greater weight than the optional factors.

Summary of Comment (page 24-28): On average, the Mercer study reflects that rural drivers with lower average household incomes average and lower home values will receive auto rate increases, while urban drivers with higher average household incomes and higher average home values will receive rate decreases. The commentator's study suggests that there is an inverse relationship between the average household income and the auto premium change which will result from the proposed regulations.

Response to Comment:

See Response to Common Comment 1.1

See Response to Common Comment 1.2
See Response to Common Comment 1.3
See Response to Common Comment 1.4
See Response to Common Comment 1.6

Summary of Comment (page 28- 30 & Appendix C): Within any given county, according to the Mercer data, rate increases get higher as the community in question shifts from urban to rural. As population density decreases, premiums will increase under the proposed regulations, according to the Mercer data.

Response to Comment:

See Response to Common Comment 1.1
See Response to Common Comment 1.2
See Response to Common Comment 1.3
See Response to Common Comment 1.4
See Response to Common Comment 1.6

Summary of Comment (page 30-31): While it is true that annual miles driven is correlated with the likelihood of getting involved in an accident, the proposed regulations will improperly inflate the significance of this correlation by pumping the mileage rating factor. This will result in rates which are not cost based and will create an improper cross subsidy of low mileage drivers by high mileage drivers. Because rural drivers have significantly higher mileage per year than urban drivers, the cross subsidy will fall disproportionately on rural drivers. The commentator relies, in a footnote, upon a study performed by Professor Kockelman of the University of Texas for this contention.

Response to Comment:

See Response to Common Comment 1.1
See Response to Common Comment 1.7

The Department commonly observes instances where insurers do not collect meaningful data regarding the correlation between some of the mandatory factors and the risk of loss. One rating factor where insurer data is lacking is the mandatory factor of annual mileage driven. By way of example, the Commissioner has observed that one insurer arbitrarily places insurers into one of merely two categories: drivers that drive less than 7,500 miles per year and drivers who drive more than 7,500 drivers per year. Other examples show similar neglect for data collection regarding the mandatory factors. The existing regulations do not encourage insurers to develop better data collection for the mandatory rating factors, because they allow insurers to fall back on the crutch of territory for auto rating. The proposed regulations will stimulate insurers to conduct better data collection for mileage and driving safety record. This, in turn, will enhance the relationship to the risk of loss between those rating factors and the rates developed under the proposed

regulations. As this relationship is enhanced, any cross-subsidy to the extent it exists, will be removed proportionately.

Summary of Comment (page 31-32): Government Code section 11346.5 requires agencies to assess the potential for adverse economic impact on California business enterprises and individuals. Farmers who are insured under private passenger automobile insurance will be affected by the proposed regulations. The impact will be particularly severe for small farmers who cannot afford the increase in insurance costs under the proposed regulations. The proposed regulations could hinder the creation of new jobs or the continued employment of current agricultural employees.

Response to Comment:

While the Commissioner has performed an assessment of the economic impact on California business enterprises and individuals in accordance with Government Code section 11346.3, the Commissioner is also cognizant of the limitations inherent with respect to such assessment, due to the complexity of insurance ratemaking. The Commissioner is confident that his assessment of the impact upon businesses and individuals is more than adequate, given the limitations of such assessment due to the constant evolution of individual insurers' class plans. The Commissioner's assessment recognizes that some degree of uncertainty will necessarily persist, due to the degree of flexibility that insurers are given in their class plan filings in order to comply with the proposed regulations, in addition to the adjustments which individual insurers will necessarily make to their class plans as they calibrate their rates to comply with the proposed regulations. It is highly doubtful that further study would bring further clarity to the effect of the proposed regulations. At best, it is likely that further study would only reconfirm an assessment the Commissioner has already made. At worst, it would unnecessarily delay the Commissioner's efforts to complete this rulemaking proceeding that has been the subject of a pending petition for rulemaking since 2003.

To the extent that small farmers utilize vehicles under a commercial automobile policy, the proposed regulations will not have an effect upon the driver's rates. To the extent that a small farmer relies upon private passenger automobile insurance for work performed, consumers who compare prices before purchasing personal automobile insurance may find that they will qualify for a lower insurance rate.

Volume 5, Comment No. 9:

Commentator: Testimony of Milo Pearson, on behalf of the Pacific Association of Domestic Insurance Companies

Date of Comment: Feb. 24, 2006 & March 6, 2006

Type of Comment: Written & Oral

Summary of Comment (pages 1-2): The proposed regulations will cause substantial premium shifting throughout the state, but especially for rural and suburban locales. Because the commentator's policyholder base is primarily located in the suburban and

rural regions of the state, this will have an enhanced impact upon the commentator's policyholders. The commentator concedes that, by increasing (i.e.-pumping) the influence of the mandatory factors, the proposed regulations' impact upon territory will be reduced. Nevertheless, the commentator submits that increasing the influence of the mandatory factors will have adverse consequences for high-mileage drivers, less experienced drivers and elderly drivers, for example. The proposed regulations will move away from cost based pricing and will create excessive rates for some drivers and inadequate rates for other drivers. The commentator acknowledges the tension between implementing Proposition 103 and making rates fair for all Californians, and submits that the proposed regulations are unfair for the reasons stated above.

Response to Comment:

See Response to Common Comment 1.1

See Response to Common Comment 1.2

See Response to Common Comment 1.3

See Response to Common Comment 1.5